CONSULTATION PAPER ON A RISK-BASED CAPITAL FRAMEWORK FOR THE INSURANCE INDUSTRY IN HONG KONG

On 16 September 2014, the Office of the Commissioner of Insurance ("**OCI**") announced the publication by the Insurance Authority ("**IA**") of a "Consultation Paper on a Risk-based Capital Framework for the Insurance Industry in Hong Kong" (the "**Consultation Paper**"). The Consultation Paper sets out detailed proposals of changes to the existing regime towards establishing a risk based capital ("**RBC**") regime.

Background

In 2011, the International Association of Insurance Supervisors ("IAIS"),which sets the global standard for the insurance sector and of which the IA is a member, has issued new Insurance Core Principles ("**ICPs**") in relation to RBC requirements. As IA is a member, it has to comply with these ICPs as soon as practicable to move towards an RBC regime.

It is proposed that the establishment of a RBC regime will take place in four Phases:

- Development of framework and key approaches - the Consultation Paper published on 16 September 2014 is the first step in this phase.
- Development of detailed rules - beginning in 2015/2016, this will be followed by another round of consultation. A quantitative impact study will be conducted for different types of insurers to ensure that the new regime is viable and practicable for the insurance industry. Amendment of legislation - it is envisaged that this will require at least two to three years to complete, including public consultations.
- Implementation - the new RBC regime will be rolled out with sufficiently long run-in period, to allow industry practitioners enough time to properly understand the new requirements and achieve full compliance with the new regime.

The Current Regime

The current regime for Hong Kong's insurance industry is essentially a rule-based capital adequacy framework, with capital and solvency requirements stipulated in the ICO and guidance notes issued by the IA.

Under the existing regime, capital adequacy of an insurer is based on the excess of assets over liabilities against the required margin of solvency. Generally, the solvency margin

requirements are proportional to the business volume and size of reserves. All insurers are required to maintain assets in excess of liabilities by at least the solvency margin stipulated under the ICO, being 100%. However, for monitoring purposes, the IA requires general insurers to maintain at least 200% solvency margin and long-term insurers to maintain at least 150% solvency margin. If an insurer's solvency level falls below these thresholds, the IA can take regulatory measures on solvency grounds.

In addition to capital adequacy, the existing rules, regulations and guidance notes provide a governing framework for insurers in relation to their corporate governance practices, valuation methodologies, investment activities and public disclosure obligations. There is currently no explicit enterprise risk management ("**ERM**") requirement, although the IA has issued a guidance note (Guidance Note on Asset Management by Authorised Insurers, GN 13) to provide some guidance on issues of risk management on business operations and investments.

The Proposed RBC Regime

The focal point of a RBC framework is to make capital requirements risk-sensitive, so that insurers that present greater risk to policyholders must carry more capital.

While the details of the proposed regime are yet to be decided and require further discussion and consultation, the IA has proposed various changes under Three Pillars:

Pillar 1: Qualitative Aspect

Proposed changes include:

- A total balance sheet approach in the assessment of capital adequacy requirements;
- Expansion of the current regime to include two explicit solvency control levels: (i) the prescribed capital requirement ("**PCR**") and (ii) the minimum capital requirement ("**MCR**"). A breach of either of these levels would trigger intervention by the IA. Details of how the PCR and MCR should be calculated requires further consultation;
- A standardized approach (i.e. set down by the IA and to be adopted by all insurers) to determine regulatory capital requirements, while retaining the flexibility to allow internal models (i.e. models created and adopted by individual insurers) subject to approval by the IA;
- The standardized and/or internal approach for determining capital requirement is to be based on specified broad categories of risk, being (i) underwriting risk (ii) credit risk (iii) market risk and (iv) operational risk. Other risks not captured by these broad

categories (such as liquidity risk, legal risk and reputational risk) are to be assessed through strong risk assessment processes;

- Stress-test based approach (specifying a set of stresses and modeling the impact on assets and liabilities) to be adopted for (i) the underwriting risk of long term business and (ii) market risk of all insurers;

- Risk-factor based approach (specifying a set of capital charges and applying that to key risk drivers) to be adopted for all other risks;

- A "tiering" approach to assessing the ability of capital resources to absorb losses, cateogirsing capital resources into different classes of quality ("**tiers**") and applying certain limits/restrictions with respect to these tiers;

- The measurement and valuation bases for determining capital adequacy should be the same as those used in general purpose financial statements prescribed by the HKFRS or IFRS (with adjustments as needed);

- Adopt an economic valuation (which reflects the risk adjusted present value of the underlying cash flows being valued) for all classes of business except Class G of long-term business (such as retirement scheme contracts or Occupational Retirement Schemes). Class G long term business will retain the valuation basis set out in the Guidance Note on the Reserve Provision for Class G of Long Term Business (GN 7).

Pillar 2: Qualitative Aspect

Proposed changes include:

- Enhanced corporate governance with more detailed requirements on internal controls and risk management than those under the current regime;

- Enhanced ERM by requiring all insurers to put in place effective ERM frameworks that provide for the identification and quantification of risks with Asset Liabilities Management policies incorporated;

- Own Risk and Solvency Assessment ("**ORSA**"), a strategic analysis process that links the outputs of risk, capital and strategic planning to determine the current and future capital requirements of an insurer, should be amended to include continuity analysis, stress and scenario testing and reverse stress testing;

- The rationale, calculations and action plans connected with the performance of ORSA should be formally documented into a report which should be submitted to the IA annually for review.

Pillar 3: Disclosure and Transparency

Proposed changes include:

- Enhanced disclosure requirements by requiring insurers to make public periodically reports on their capital resources and capital requirements;
- To obviate any issues relating to publicizing sensitive firm-specific information regarding risk and capital, these disclosure requirements will be phased in;
- Further consideration in Phase II of whether and what information should come under the scope of external audit.

Group Wide supervision

The Consultation Paper also sets out proposals relating to group wide supervision of insurers that have onshore and offshore operations, as well as group and sub-group operations. The IA proposes to adopt a three-tier group-wide supervision approach, which one of the three tiers that will apply to a solo entity and its group will depend on the structure of the group in question.

Comment

The proposed move towards a RBC regime would see Hong Kong moving in line with the EU, whose Solvency II regime is scheduled to be implemented in all 27 Member States from 1 January 2016. The proposed RBC regime is very similar to Solvency II, which is also a risk-based system based on the same three Pillars of Quantitative (capital requirements), Qualitative (corporate governance and supervision) and Disclosure and Market transparency. It will also see Hong Kong becoming more aligned with international insurance standards, such as Singapore and Australia, which already adopt a similar risk-factor approach.

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